

Chapter XII. Expansive prosthetics funded with money creation in state fiat money regimes

Section 1. From commodity money regimes to state fiat money regimes

Fickle origins of state fiat money

In the previous chapters, prosthetic spending was already being supported by money creation, but the money creation was primarily private bank fractional reserves credit money creation only. State and central bank credit money creation or even money creation by fiat money showed up experimentally and transitorily in war or other emergencies but disappeared again after the war was over. This remained so until even after World War I and World War II, at Bretton Woods, and was only to change in 1971, when Richard Nixon un-did the latter restoration of a commodity money regime. Only now fiat money became the exclusive base money of the US and of most of the world. This ultimately provided states and central banks with a permanent money creation gland of their own, which was utterly more powerful than private bank fractional reserves credit money creation. At first, states did not use state fiat money creation as the primary means to finance prosthetics but as a tool to support private bank fractional reserves money creation. They used it to push interest rates down and to bail out private banks out where required. States also set up new legal frameworks and institutions, to ease to manage the growing debt, which was enabled by state fiat money.¹

1 *John Law* was one of the first writers who connected the idea that an increase of money would further trade and employment with the conviction that money without intrinsic value could be used. See *Murphy*, John Law (1671–1729) in: *Faccarello* (2016) page 17). Goethe had Mephistopheles present the advantages of state fiat money creation to the Kaiser in his *Faust II*, published 1832 (Erster Akt, Lustgarten, line 6120 et seq., 6075 et seq.): “Ein solch Papier an Gold und Perlen statt./Ist so bequem, man weiß doch, was man hat, .../Beschämt den Zweifler, der uns frech verhöhnt,/Man will nichts anderes, ist daran gewöhnt./So bleibt von nun an allen Kaiserlanden,/An Kleinod, Gold, Papier genug vorhanden./Schatzmeister (to Kaiser): “Seht Eure Stadt sonst halb im Tod verschimmelt,/wie alles lebt und lustgenie-

Under a system of gold or silver money, without fractional credit money creation, states had very limited space to maneuver. When they minted coins out of precious metals, decided upon their weight, embossed a currency unit, and put a nominal amount and emblem on it, they were, as we observed,² only able to earn a very small seignorage. Yes, they could issue the coins at a face value slightly above their production costs (mainly the content of precious metals), but no more, and could, thus, realize only a meager add-on. Markets would typically accept such a small “honest” profit in view of the additional value-in-use, which accrued from the convenience of the coins being embossed. If, however, in war, catastrophe, or out of frivolity, states attempted to increase the seignorage to a quarter, half, or the full amount of the value-in-exchange of the precious metals used (or if they debased the precious metals by an eighth, a fourth or half of their weight with un-precious metals, which is the same thing), then markets would often no longer accept these coins at their full nominal value.³ This problem wholly disappeared with the introduction of fiat money regimes. Markets would now willingly swallow huge amounts of coins, paper or bookkeeping entries *with zero percent* gold or silver content or backing! The small money-creation maneuvering space that states had during commodity money exploded with the advent of fiat money regimes.

A near 100 %-seignorage at the issuance-moment

In addition, before states could dream of putting a seignorage on commodity money coins or debasing them, they first needed tons of gold or silver as base material. If they could not get hold of them, then their only option was to withdraw existing coins from the circulation and reissuing them at the same or a superior nominal value, albeit with a lower gold or silver content. That did not only look bad, but again the overall re-issuance profits were limited. They depended on the volume of money in circulation in their territory, on the percentage states would get into their hands, what degree of debasement the money already had, and how much more debasement the market would tolerate. There could also be technical problems.⁴

ßend wimmelt./Obschon dein Name längst die Welt beglückt,/man hat ihn nie so freundlich angeblickt.”

2 See on page 63.

3 Some late Roman emperors earned a particular bad reputation for pushing such attempts too far. In particular the “soldier emperors”, e.g., Valerian I and Gallienus, who lowered the silver content to only 5% (*Beck/Bacher/Hermann* (2017) page 40).

4 If you want to withdraw commodity money from circulation, to reduce the precious metal content from 80% to 66%, you have to first check each coin, which you manage to get a hold of concerning its prior state of debasement. One could surmise that differences in the embossing of coins served the purpose to easily distinguish coins of different debasement in later debasement rounds. The coins have, then, to be carried to a mint to do the work.

States, moreover, ran into difficulties to get rid of the additionally debased coins at the unjustified higher nominal value: *The advantage for the state lies only in the singular moment of initial issue or initial re-issue.* To realize it, the state had to induce somebody to deliver commodities, including gold or silver, in the nominal value of the coins *without increasing the prices* of the goods delivered. Unfortunately, the recipients of payments from the state were often suppliers, which were close to the state and on whom the state depended, e.g., military suppliers, the state's construction firms,⁵ the emperor's luxury suppliers, bureaucrats or soldiers, whom it needed to treat well and not to alienate. Still, to repeat, the first bringing-into-circulation of the debased coins was the only opportunity at which the state could make a profit from the debasement or the seignorage. Wealthy merchants and nobles around the state who were asked to accept the new bad money, thus, mostly had no option but to try to outsmart the state (pretending to have no goods to supply or trying to increase prices) while still swallowing the bad money in a first step. They would, then, of course, use their superior might to *forward it to others, which were weaker than themselves.* In the end, most certainly, the particularly debased money ended up in the hands of the lowest rank with the fewest alternatives, probably soldiers and poor peasants. All these options of states were unpleasant, but in a pure commodity regime no further options existed. No wonder that states desperately hoped for the alchemists to make progress in their laboratories.

States' simplified relations to banks in modern times

States had intense relationships already with the predecessors of modern banks, e.g., to money loaners, and usurers, the Lombard and, in particular, the Jews, as the most professional dealers in money, in the Middle Ages. States were their loan-customers, were indebted to them, were advised by them, partnered with them, regulated them, asked them gently to waive some of their repayment claims from time to time, and occasionally expelled them from their territory, or, if they were Jewish, expropriated them or even unleashed or supported pogroms or killed them. Then again, they called "their" expelled Jews or other money lenders back.⁶ Once modern banking was established, states particularly admired the banking houses' power to create money through fractional reserve credit money. Warfare financing ignited boosts in the development of private banks and states forged alliances with them. Banks assumed a leading role in the financing of the warfare between the Italian city states in Renaissance Europe by organizing the issuance of bonds.⁷ In Britain,

5 They tend to also be cheated often by the state, see the case of Faffner and Fasolt who were cheated by Wotan in Wagner's Ring.

6 See *Sombart* (1902) volume I, page 266, 267.

7 *Ferguson* (2008) page 70.

the need to finance the build-up of the Royal Navy even induced the formation of *The Governor and Company of the Bank of England*, the later Bank of England, as such in 1694. Against granting a loan of £1.2-million-pounds to the state at 8 % interest, the bank received the privilege of issuing (otherwise uncovered) banknotes in the same amount; in other words, it was authorized to create money in the amount in which it had loaned bullion to the state. During the Napoleonic wars, in 1797, the English cabinet released the bank from redeeming its bank notes in commodity money. This might lead to interpretational questions and legal considerations. The interpretational question was what the release meant precisely. Did it mean a switch into a temporary or even general fiat money regime or just some kind of an emergence law under which the opening of legal proceedings for the conversion of credit money bank notes and credit money account entries into commodity money was denied for the moment? This remained unspecified, but the British cabinet's actions pointed to what would become a widespread practice of states in extraordinary situations, de facto flipping what had been credit money into fiat money by ordinance while leaving the question of whether the fiat money would again be restored to credit money later an open one. The legal issue was whether a cabinet was at all entitled to "release" a debtor from a debt (normally the government cannot interfere in contractual relationships). The crucial motive for the state-granted exemption from the convertibility was, of course, not the fear for the security of existing banknotes-holders – the bank's solvency might already have been poor previously and the position of its existing creditors was not greatly improved by the exemption –, but *to protect the banks' capacity to create further money*, which the state needed for the war or for whatever crisis.

Dirty origins of state fiat money

Other countries aside the UK also ventured into credit money creation and slipped into de facto state fiat money creation from there. When Louis XIV died after decades of warfare in 1715, his state finances were in disrepair. The situation was so bad, indeed, that *John Law*, a Scotsman, was allowed to found the *Banque Générale privée* to bring relief in 1716. This bank with a stated capital of Livres 6 million could cover 3/4 of its stated capital with largely depreciated state notes (bonds), which had financed Louis XIV's wars; the actual paid-in capital was less than Livres 3 million.⁸ The bank, which was to become the *Banque Royale* in 1719, issued bank notes, *monnaie papier*, in the amount of its stated capital of Livres 6 million. This resulted in a volume of fractional bank credit money creation in excess of the total *monnaie papier* over the sum paid in silver, plus the residual value of the old state notes.

8 Ferguson (2008) page 140.

Following 1862, the Union, in order to finance the US civil war for the North without the involvement of a central bank – the Fed was only founded in 1913 –, issued so-called “Demand Notes” which were redeemable against gold, hence state credit money, in the limited volume of fifty million dollars. Unlike most or all other notes in use, which were only printed on the face-side, they were printed in green on the reverse-side (hence the term “greenbacks”). Shortly thereafter, the Union issued several hundred million of so-called “United States Notes”, which also had a green back, and were also called “greenbacks”, but which were *not* redeemable against gold. It was said that a significant part of the public believed that the second issue was as redeemable as the first. Nevertheless, this second issue helped the North to win the war. From a monetary point of view, the first issue of “Demand Notes”, was clearly credit money because of its legal convertibility into gold money; whether it led to money creation would have depended on whether the claims were or were not fully backed by gold reserves held by the Union.⁹ The second, larger issue of “United States Notes”, given the lack of convertibility, was clearly fiat money. Whether it led to money creation depended, as above, on whether while fiat money was issued gold reserves were built up. As this was largely not so, it overwhelmingly constituted money creation once more. As to the “solvency-concern”: “United States Notes” were fiat money and they would as such, without additional measures, never convey any security for their holders. However, Congress allowed holders to use them instead of gold to pay taxes and made it legal tender, thereby ascribing significant value to them. At least as long as the North remained stable, he who had subscribed to them, had a good chance not to be punished for his patriotism. “United States Notes” were crucial to pay for soldiers and to purchase military equipment to ascertain the win for the North. In fact, after its victory, the Union promoted the initially non-convertible notes to be redeemable against gold.¹⁰

Germany and Japan established central banks in the second half of the 19th century. Like other countries, their monetary regimes remained based on commodity money, but they allowed money creation by the central bank by issuing central bank credit money beyond what the central bank was obliged to hold as gold or silver reserves (in addition to the ongoing money creation by private banks through fractional reserve credit money).

As in prior wars and emergencies, these systems – commodity money regimes, but allowing a certain fraction of bank and state fractional reserves money creation

9 Most likely the larger part of the issue, indeed, also constituted money creation. Note once more that the “solvency-concern”, as we know well, is a different issue. The security of the claim for conversion of the credit money into precious metals (or other good value) depended upon the Union’s general solvency, on whether or not it would win the war in particular.

10 See https://en.wikipedia.org/wiki/Demand_Note.

– came under stress in World War I and World War II. Most warring states at first increased the volume of central bank notes, which were not backed by gold or silver reserves, and, as this did not suffice, either officially or factually suspended the convertibility or redeemability of their central bank notes in gold or silver. This may not even have made a tangible difference for the holders of the notes, as, whether they were holding notes representing central bank or state credit money or state fiat money, their value always depended on the victory of the respective issuing country. After both world wars, World War I and World War II, the main Western countries, in a way quite astonishingly, once more returned to commodity money, e.g., the UK through *Winston Churchill* in 1925 and, after World War II, as already mentioned, the US and the whole Western block, after the Bretton Woods conference of 1944.

Section 2. State fiat money creation aside private bank credit money creation

From occasional experiments with state fiat money to a new monetary regime

While the occasional suspensions of convertibility in regimes of commodity money during emergencies had always ended with the restoration of a commodity money regime, as a side-effect it had allowed states to experiment with state fiat money and to prepare the ultimate full transition to state fiat money. And this day came when state fiat money creation gland was ultimately established lastingly as the superior money creation gland. If a date is needed, many authors point to the announcement by Richard Nixon of 15 August 1971 to temporarily (!) suspend the conversion of US-Dollars into Gold (at the fixed rate of US\$35 at the time) – likely with the immediate purpose of protecting the remaining US Gold reserves from being exchanged against fractional reserves bank credit money created in order to finance the Vietnam war. As we now know, that “temporary” suspension ignited a worldwide system-switch and represented the final departure from commodity money.

Technically, the swap to state fiat money regimes did not actually require much more than the declaration of “non-convertibility” of the already issued credit money (of banks, central banks, or states); indeed, the change could even lastingly officially remain “temporary”. Moreover, existing notes and coins did not have to be taken out of circulation and the gold and silver, which was sitting in the vaults of the treasury, could stay there. Yes, theoretically, it *could* have been demonetized to realize its value-in-exchange as commodity in a one-time coup. (The transition to state fiat money had set free the value-in-exchange, which gold and silver coins carried “piggyback”). But there was no rush to use this newly accrued option, and, indeed, there were less reasons than ever before to touch the gold and silver – states had just ac-